MONEY MATTER$

KENTUCKY DEPARTMENT OF FINANCIAL INSTITUTIONS

Regulatory News for Kentucky's State-chartered Banks

LEGISLATURE EXPANDS DFI RULE ON EXAMINING UNCLAIMED PROPERTY

During the 1998 legislative session, the escheat statutes were amended to provide the Kentucky Department of Financial Institutions (KDFI), as agent for the Kentucky State Treasurer, responsibility for conducting on-site examinations of financial institutions that are in apparent noncompliance with statutory requirements. However, the State Treasurer retains jurisdiction for enforcement of escheat noncompliance. Factors that prompt an on-site examination include: The institution has not submitted a report to the State Treasurer's office, the institution has submitted reports that state they have no unclaimed property, the institution fails to report types of unclaimed property normally reported by like institutions, the amounts reported are not comparable to like institutions, or information is provided by other government agencies that an institution is holding unclaimed property that has not been reported. Institutions that KDFI is authorized to examine include state and national banks, state and federal credit unions, and state and federal thrifts.

Several KDFI employees recently participated in a training program to become familiar with the escheat process. With this training complete, the Department anticipates that escheat exams will commence in the second half of 2000. KDFI will be working from a list of institutions provided by the State Treasurer's office. To stay off the list, all institutions should review their escheat policies and practices and follow Chapter 393 of the Kentucky Revised Statutes in properly escheating property.

INSIDE

Printed with State Funds

Career Employees Named to Top Posts

Several management changes have occurred within the Department of Financial Institution in recent months. On January 13, 2000, Ken Pennington was promoted to Deputy Commissioner. Ken has been with the Department for 17 years. David Coyle was promoted to Director of the Division of Financial Institutions on April 6, 2000. David has been with the Department for 15 years. Lastly, effective July 1, 2000, Mike Wilson was promoted to Examination District Manager for the Lexington District of the Bank Branch. Mike has been with the Department for 14 years.

NEW LAWS WILL EASE REGULATORY BURDEN

The 2000 Legislative Session is over, and Kentucky State Banks should be pleased with the changes that will impact the industry. The Department's banking bill, Senate Bill 169, was passed, and many of its provisions became effective on July 14, 2000. The changes discussed below are designed to achieve two objectives: 1) Enhance the value of the Kentucky State Bank Charter, and 2) Reduce regulatory burden.

A. "SUPER PARITY"

The new legislation will allow a Kentucky State Bank, with a CAMEL composite rating of 1 or 2 at the most recent state or federal regulatory examination, to engage in any activity that a state or national bank and thrift, wherever located, can engage in. Before engaging in these activities, the bank will need to obtain an affirmative legal opinion from its legal counsel stating that the activity is permitted. While it is not required that the bank notify the Department prior to engaging in a new activity, a letter would nevertheless be appreciated.

The Department is taking the position that while "activity" would include a myriad of opportunities, such as equity investments, it does not include changes to existing interest and fees limitations contained in Kentucky law. Kentucky State Banks will be expected to adhere to current Kentucky provisions when granting and collecting loans.

B."EXPRESS BRANCHING"

New provisions in the law will allow a well-managed and well-capitalized Kentucky State Bank to establish branches, move offices, and establish loan production offices without Department approval. The Department is developing an administrative regulation that will establish the procedures and conditions for this opportunity. Hopefully, this regulation will be effective by the fourth quarter of this year.

A Kentucky State Bank will need to meet the following criteria to take advantage of this expanded opportunity:

1. Must be well-capitalized pursuant to federal regulatory guidelines

2. Must be rated a CAMEL composite 1or 2 at the most recent state or federal regulatory examination

3. Must have a Management component rating of 1 or 2 at the most recent state or federal regulatory examination

4. Must be in compliance with the 40% fixed assets/capital ratio after branch, relocation, LPO is completed

5. Must not be under any informal or formal regulatory action

Additionally, the bank must provide two notices to the Department: 1) When the Board of Directors formally approves the branch, relocation, or LPO. [The bank needs to certify with this notice that it is in compliance with the above criteria.], and 2) Within 30 days after the new office is open for business.

The bank will also need to provide written notice to all banks headquartered in the county where the new office will be located.

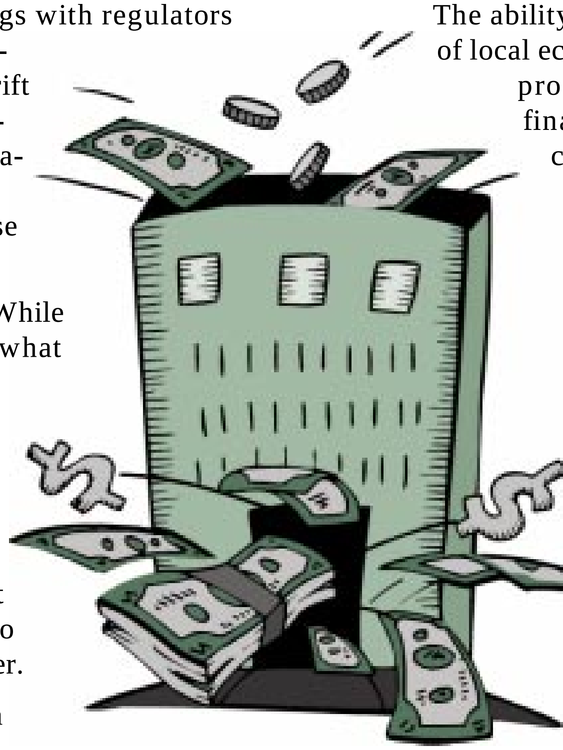
C. COURIER SERVICES

SB 169 allows Kentucky State Banks to provide courier services, as requested by some of Kentucky's smaller institutions.

The above legislative changes, along with the advent of statewide branching, gives Kentucky State Banks greater opportunities than ever before.

REGULATORS VOICE CONCERNS ABOUT NEW ENVIRONMENT

Bankers are tired of hearing the same old gloom and doom prognostications about the banking environment being proffered by their friendly bank regulator. During recent meetings with regulators representing all the federal agencies responsible for bank and thrift regulatory concerns in the Commonwealth, and later with regulators from at least six other state banking agencies, all voiced these common concerns:



☛ 1. Increased delinquencies: While past due credits have not shown what could be defined as a precipitous jump, there is evidence that this ratio is slowly beginning to increase. The over-riding concern is that delinquencies are increasing just slow enough that management is not recognizing it as a trend, and therefore, failing to respond in an appropriate manner.

☛ 2. Loan documentation: As a banking acquaintance once said, "The trouble with you examiners is that you deal in a multiplicity of technicalities." How true, and unfortunately the number and frequency of loan documentation exceptions are coming to the forefront.

☛ 3. Liquidity: More and more dependency on large volatile deposits, brokered deposits, and deposits from sources other than the local economy are being utilized to fund loan demands.

☛ 4. Earnings: Net interest margins are beginning to shrink in the face of financial institutions' failing to price their credits commensurate with the perceived risk and cost of funds.

☛ 5. Management: Today we are facing a cadre of bank officers who, under most situations, would be considered seasoned veterans. We are talking about individuals with ten years of experience who have packaged a multitude of varying loan demands and who have experienced little adversity in the lending environment. This cadre of bank officers has also had the privilege of operating in the best, sustained economic period ever experienced in modern times. The ability of the officers to recognize signs of local economic downturns and to take proactive steps to insulate their financial institutions from inordinate credits risks, has yet to be tested.

☛ 6. Audit functions: Regulators voiced some concern about the process banks are employing in selecting firms to perform external audits. More and more we are hearing, "They were the lowest bidder." as justification for retaining an audit firm. Little concern is being accorded to the firm's or its personnel's background –experience or qualification – to perform such an audit. Also, bank management is not looking at the experience or seniority of personnel performing the audits regardless of whether the audit is being conducted by one of the large national firms, by a regional firm, or by a small local firm. **Bank CEOs :be sure you get what you think you are paying for**.

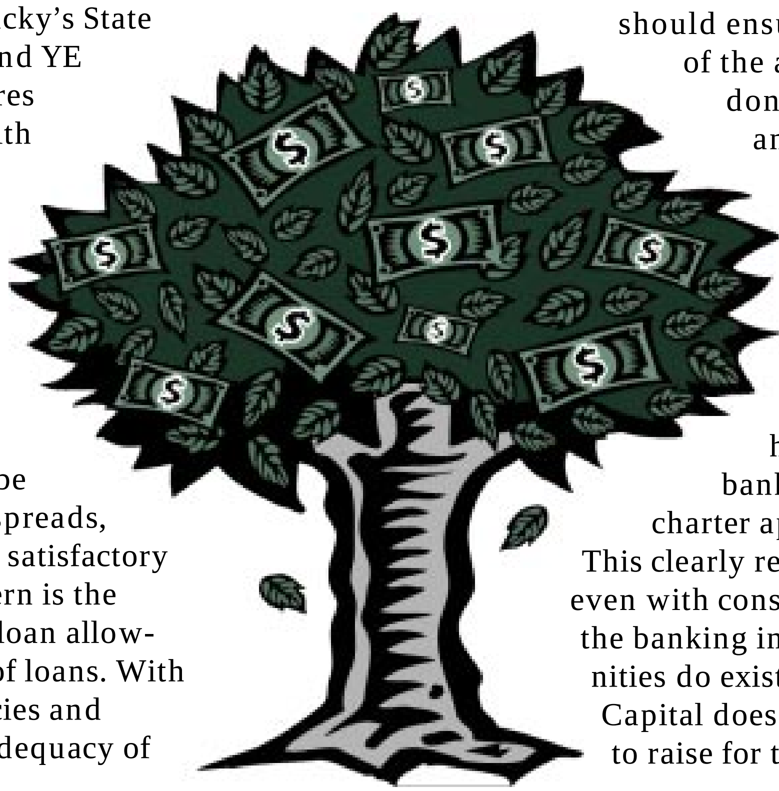
In querying examiners as to what they perceived as the catalyst driving bank management, their almost unanimous response was one word, "competition." Today bankers are being inundated with requests that ten years ago would not have received the slightest consideration. But in order to compete on today's banking field of play, bankers are not only giving consideration to such requests but are also trying to devise ways to make the requests more palatable. This is in no way an admonishment to bankers to stop making loans or developing new strategies to make credits. However, it is a word of caution not to let the word "competition" drive you to accept larger than normal risks and exposure the bank to unacceptable consequences.

STATE OF BANKING IN KENTUCKY

	National Banks Kentucky 12-31-99	State Banks Kentucky 12-31-99	State Banks Kentucky 12-31-97
Number of Banks	57	191	204
Total Assets *	24,666	26,773	25,022
Yield on Earning Assets	7.61	8.08	8.46
Cost of Funds	3.71	3.77	4.04
Net Interest Margin	3.90	4.32	4.42
Net Charge-offs to loans	0.55	0.26	0.36
Return on Assets	1.24	1.32	1.35
Loan Allowance to Loans	1.34	1.27	1.37
Leverage Ratio	7.02	9.51	9.43
Total Risk-Weighted Capital Ratio	11.59	14.82	15.16

The table above shows the financial performance of Kentucky's State Banks as of YE 1999 and YE 1997, and also compares their performances with Kentucky's National Banks for YE 1999.

The data, taken as a snapshot, indicates that Kentucky's State Banks are in generally healthy financial condition. Earnings continue to be squeezed by interest spreads, but ROAA remains at satisfactory levels. Of some concern is the declining level of the loan allowance as a percentage of loans. With increasing delinquencies and some leakage in the adequacy of the loan allowance, bank management should ensure that its assessment of the allowance account is done accurately and that any outages are funded immediately.



The number of Kentucky State Banks continues to decline due to mergers and consolidations. However, the Department has chartered 14 new banks since 1996, with four charter applications pending. This clearly reflects the notion that even with consolidations occurring in the banking industry, market opportunities do exist for these new charters. Capital does not seem to be difficult to raise for these new entrants.